



THIS MATERIAL REPRESENTS THE CONSIDERED OPINIONS OF THE BUSINESS PRACTICES COMMITTEE AND THE BOARD OF MANAGEMENT OF THE CORPORATION OF BC LAND SURVEYORS REGARDING REASONABLE STANDARDS FOR FINANCIAL COMPENSATION AND CONTRACTING OF PROFESSIONAL SURVEY SERVICES. INDIVIDUAL SURVEYORS SHOULD ALSO CONSIDER ANY UNIQUE ASPECTS OF THEIR INDIVIDUAL PRACTICES IN ORDER TO DEVELOP APPROPRIATE FEE SCHEDULES.

BCLS

Business Practices Committee BULLETIN

What is profit

From Bulletin 5 “Billing Rates or Payroll Multipliers” we discussed The Rule Of Three which is a common rule used by consulting firms to calculate their billing rates. The basic assumption is that every consulting firm incurs overhead and benefits that equal the salary component in their expenses. In addition every Consultant should produce a PROFIT that is equal to their salary or:

$$\begin{array}{rcl} 1/3 & = & \text{Consultant's salary} \\ + 1/3 & = & \text{Overhead + Benefits} \\ + 1/3 & = & \text{PROFIT} \\ & = & \text{Total Yearly Revenues} \end{array}$$

By any other name PROFIT is what's left after you've paid your expenses including your wages. It is the consequences of what happens in and to your business. Some of these things are within your control and some of them are outside your control. There is no sense wasting your effort on things beyond your control, rather, focus your efforts on things you can control, namely:

- (1) **PRICE** you charge for the service you sell.
- (2) **QUANTITY** of services you sell.
- (3) **VARIABLE COSTS** are the costs you incur to produce the services you sell, so named because they increase or decrease as your sales increase or decrease.
- (4) **FIXED COSTS** are the costs you incur whether you make any sales or not. They are called fixed costs because they do not change with fluctuations in sales volume, at least not on a day-to-day basis.

It is important to note that profitability can be increased by taking action to increase or decrease any of the 4 factors, as long as some conditions are met.

For instance, if you increase the price the sales volume could either remain unchanged or decline. If sales volume declined the decline would have to be less than the offset created by the price and resulting profit decline.

It is important to remember that no single factor can be considered without considering its impact on each of the other factors. One should also remember that a profit improvement strategy may involve either an increase or decrease in each of the 4 factors. There is no standard formula for improving profitability; it depends entirely on specific circumstances and the relative strengths and weaknesses of your business. Lastly, a favorable change in price and/or your variable costs will improve your gross margin per dollar of sales.

In other words, any profit improvement strategy must focus on either or both of 2 things:

- a) achieving a higher gross margin per dollar of sales by increasing the price and/or reducing variable costs and / or
- b) achieving greater sales per dollar of fixed costs by increasing the productivity of those things which have a fixed cost.

Summarizing the above, let's look at the profit improvement potential that would arise from a modest improvement in each of the 4 factors.

To demonstrate the powerful effect of small changes, a 5% improvement in each of the four factors will be made on producing and selling location certificates:

Function	Base	% Charge	Result
1. Price/Location Certificate	\$450	5% inc.	\$472.50
2. Volume	<u>x100</u>	5% inc.	<u>x105</u>
Total Revenue	\$45,000		\$49,612.50
3. Variable Costs (\$240)	<u>-\$24,000</u>	5%dec.(\$228)	<u>-\$23,940.00</u>
Gross Margin	\$21,000		\$25,672.50
4. Fixed Costs (\$160)	<u>-\$16,000</u>	5%dec.(\$152)	<u>-\$15,960.00</u>
Net Profit	\$5,000		\$9,712.50

From the above a 5% favorable change in each of the 4 factors without a consequential impact on either of the other 3 would increase your profit from \$5,000.00 to \$9,712.5; an improvement of 94%. But assuming there will be no consequential impacts is living in a dream world, it is a fact that small improvements made to each of the 4 factors that determine your profit will combine to give a staggering overall impact. Rework the above example using a 5% increase in either or both of the costs to see the effect on your bottom line.

Remember, your gross margin is the difference between the price of your product or service and what it costs you to produce it. Therefore, the only way to increase your gross margin is to sell at a higher price or buy/produce at a lower price. In most situations you will have limited access to buy at a lower price. For this reason your selling price is the initial variable.

Most operators in a slow economy notice first off that their volume decreases. The immediate survival instinct is to think about reducing the price. This is the wrong philosophy for 2 reasons. Firstly, the volume decrease is a result of the slow economy and when there is less volume available one requires a significant price movement to have a meaningful effect on the volume and secondly a so called modest 10% decrease in price has a significant negative impact on the profit as one can see in the following example.

Function	Base	%Charge	Result
1. Price/location certificate	\$472.50	-10%	\$425.25
2. Volume	<u>x105</u>	nil	<u>x105</u>
Total Revenue	\$ 49,612.50		\$ 44,651.25
3. Variable Costs (\$228)	<u>-\$ 23,940.00</u>	nil	<u>-\$23,940.00</u>
Gross Margin	\$ 25,672.50		\$20,711.25
4. Fixed Costs (\$152)	<u>-\$ 15,960.00</u>	nil	<u>-\$15,960.00</u>
Net Profit	\$9,712.50		\$4,751.25

Decreased Price	=	\$ 425.25
variable costs	=	<u>-228.00</u>
gross margin	=	\$197.25
fixed costs	=	<u>-152.00</u>
Net Profit	=	\$45.25/certificate

$$\frac{\$9,712.50}{\$45.25} = 215 \text{ certificates required to match the net profit.}$$

From this one can see you need to double the volume in order to maintain your profit margin. Try re-working the above using a 5% increase in price and see the effect on the volume requirement to maintain your profit margin.

Without doubt the biggest single barrier preventing small business owner/managers from making an acceptable profit is their refusal to charge a price which will enable them to achieve it. You are not in business to match the price your competitors set; you are there to service your customers.